May 26th, 2015

MERITAS ADVISORS

Comprehensive Wealth Management

MONTHLY INVESTMENT OUTLOOK

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MORE FROM MERITAS

You can read more from our chief economist Lenore Elle Hawkins at TheStreet.com where she publishes weekly articles along with co-author Chris Versace, (not affiliated with Meritas Advisors). Lenore and Chris are also writing Cocktail Investing, scheduled to be published in the summer and is currently available for pre-order from Amazon.

Meritas Advisors structures portfolios to meet our clients' personal goals and preferences within the scope of their risk tolerance. We strive to manage risk most effectively by utilizing a wider blend of asset classes, with the objective of achieving our client's goals with a reduced amount of overall portfolio volatility.

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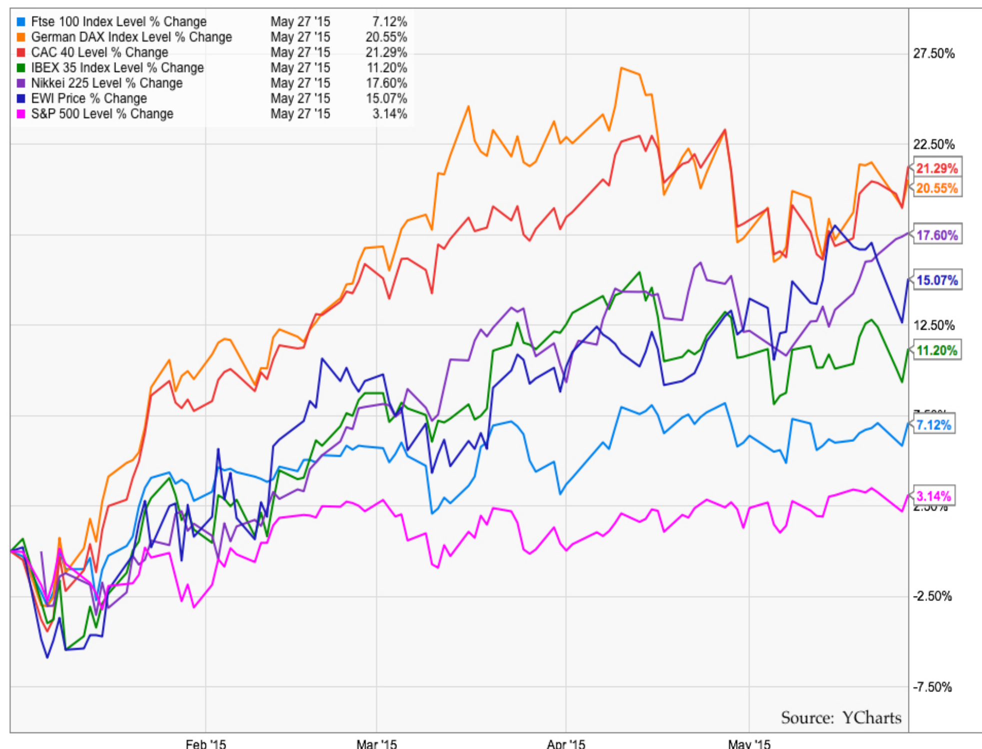
Dear Clients and Friends:

Last month, for the first time in our history yours truly wasn't able to put out our monthly newsletter. It turns out, writing a book has moments in which one finds oneself banging one's head against the desk, fingers throbbing from the relentless clackity, clackity, clack, begging God to just make it all go away…. My gracious partners here at Meritas took pity on me and gave me a hall pass for the month. Here we are in May and as they say in Monte Python's In Search of the Holy Grail, "I got better." The global markets keep getting more and more interesting as we get deeper into 2015, so without further adieu we bring you a slightly longer monthly update, just in case you really, really missed us.

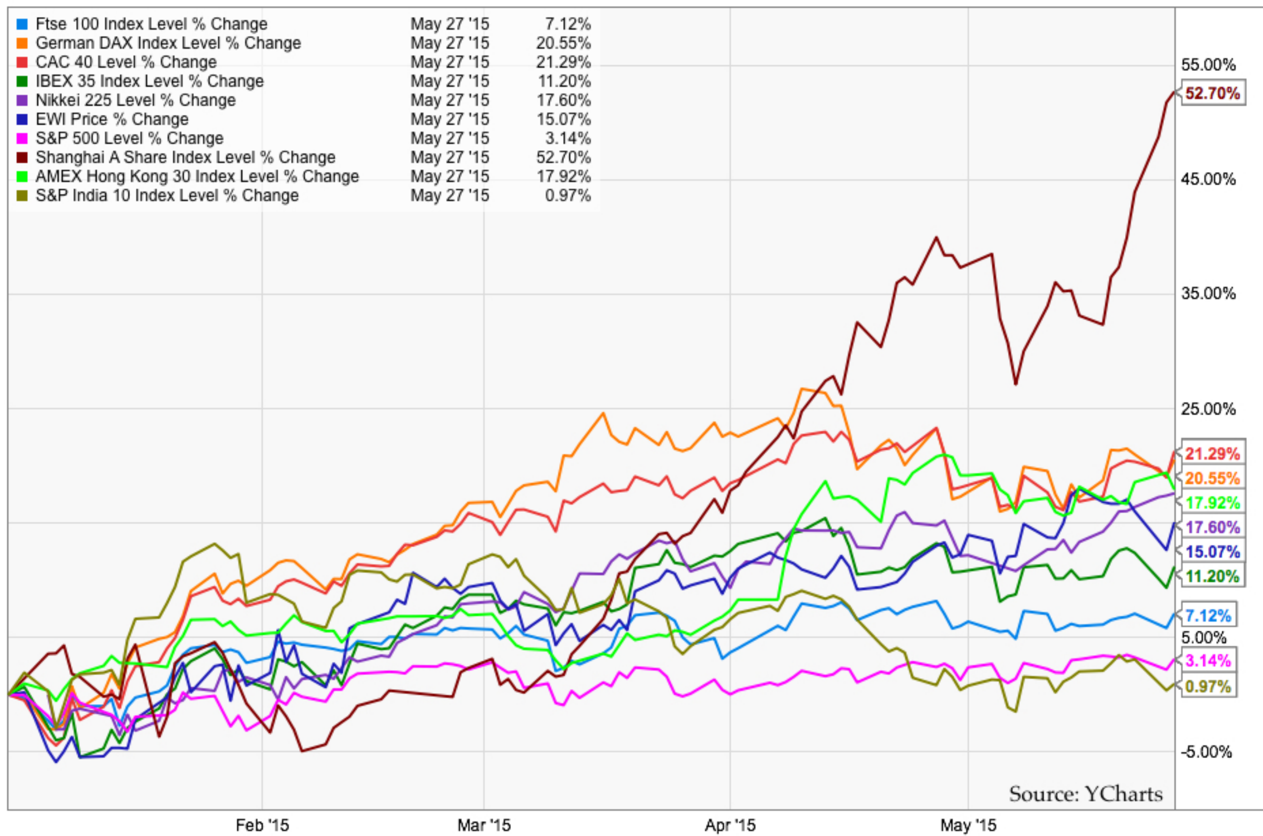
Lenore Elle Hawkins, Meritas Advisors Partner, economist and recovering author who may have just found the most perfect workout, wine and yoga, OK!? (click here).

Market Update

The S&P 500 continues to lag the much of the rest of the developed market indices, essentially unchanged over the past three months, up a meager 0.29% since March 1st. Most global ETFs have continued to rise despite the impressive string of disappointing economic reports. A June rate hike by the Federal Reserve looks to be off the table, but given the exceedingly tight correlation between monetary policy and stock indices around the globe, it is unsurprising that the U.S. markets are on pause as analysts search their crystal balls for indicators of when the Fed may make its move.



That global chart gets a lot more interesting when we include one other country, China.

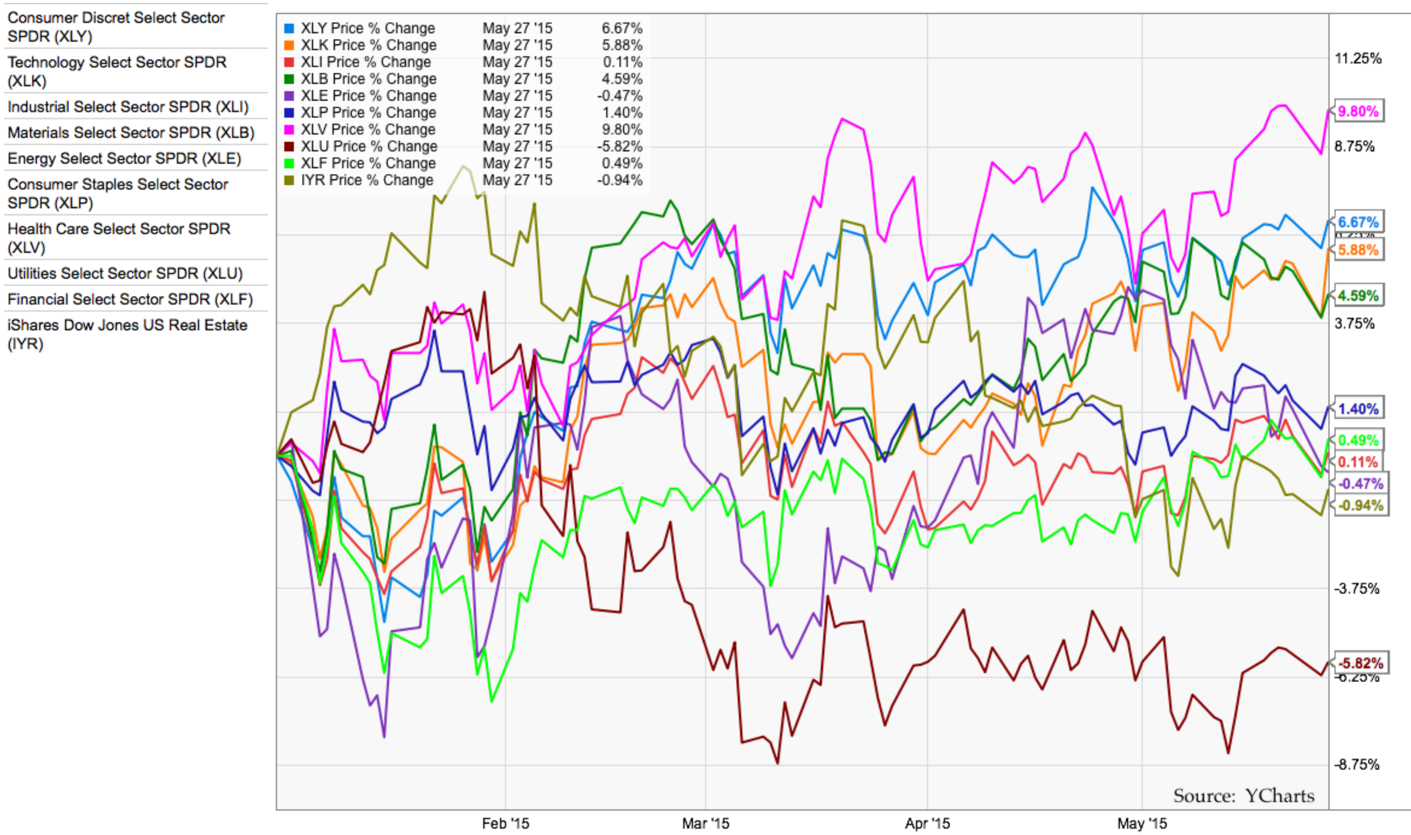


The past year China's two main stock markets, Shanghai and Shenzhen, experienced an enormous bull run with their A shares indices up over 140% and nearly 180% respectively versus the S&P 500 and NASDAQ which have returned 10.7% and 20.2% respectively. Later on we'll talk about just what is going on with China!

Bottom Line: *Stock performance continues to be highly correlated with the degree to which a nation follows loose monetary policy. The U.S. markets are likely to not make major moves in any direction until Fed interest rate policy becomes clearer. As we'll discuss later, stock performance can also be materially affected by changes in supply and demand, like we are seeing in China and as we've seen in the U.S. with share buybacks.*

PE Ratios and Sector Performance

The next chart shows that within the U.S., the healthcare sector, consumer discretionary and technology have led with returns of 9.8%, 6.7% and 5.9% respectively while utilities have vastly underperformed, falling 5.8% year-to-date. But why?



Recall that a stock price is best analyzed by looking at the price-to-earnings or P/E ratio. That way we can determine if the stock price has increased because the company is making more money, or because the market is willing to pay more for each dollar the company earns. You can think of a PE ratio as the market's relative valuation of a company's (or sector's or index's) future potential.

For example, the market has lower earnings growth expectations for company with a P/E ratio of 10 versus a company with a PE ratio of 15, which makes rather intuitive sense. Here's an example of why. Today company A and company B both generate $1 per share of income and have the same stock price. Using your magical crystal ball you could see that over the next 5 years, company A would grow its earnings to $1.20 per share while company B would grow to $2.00 per share. You would be willing to pay more for company B's stock than company A's. Since today they have the same earnings, the P/E ratio for B would be greater than A.

There is no rule or mathematic basis for what a company's P/E ratio should be. The ratio is useful only in relative terms, meaning comparing one company to another or one sector to another or changes in the ratio over time. To give you context however, the P/E ratio for companies in the U.S. has averaged between 14 and 16 historically.

PE ratios also have a major limitation in that they are impacted by a company's capital structure, meaning if it raised money through equity (investors) or through debt (by borrowing). In our February newsletter we discussed the impact of share buybacks, (which reduce the number of shares outstanding) by issuing debt; it's a subtle (sneaky?) way to make earnings per share look better when all that's really happened is a shuffling of the capital structure!

The chart at right shows the various P/E ratios for all ten sectors in the S&P 500. The first column shows the P/E ratio for each sector at the bottom of the market in 2009, the next at the end of last year, then at the end of last week then how much the PE ratio has changed since the bottom of the market and finally how much it is changed since the beginning of the year.

As you can see from the chart, health care P/E ratios have expanded the most since the financial crisis, followed by industrials and materials.

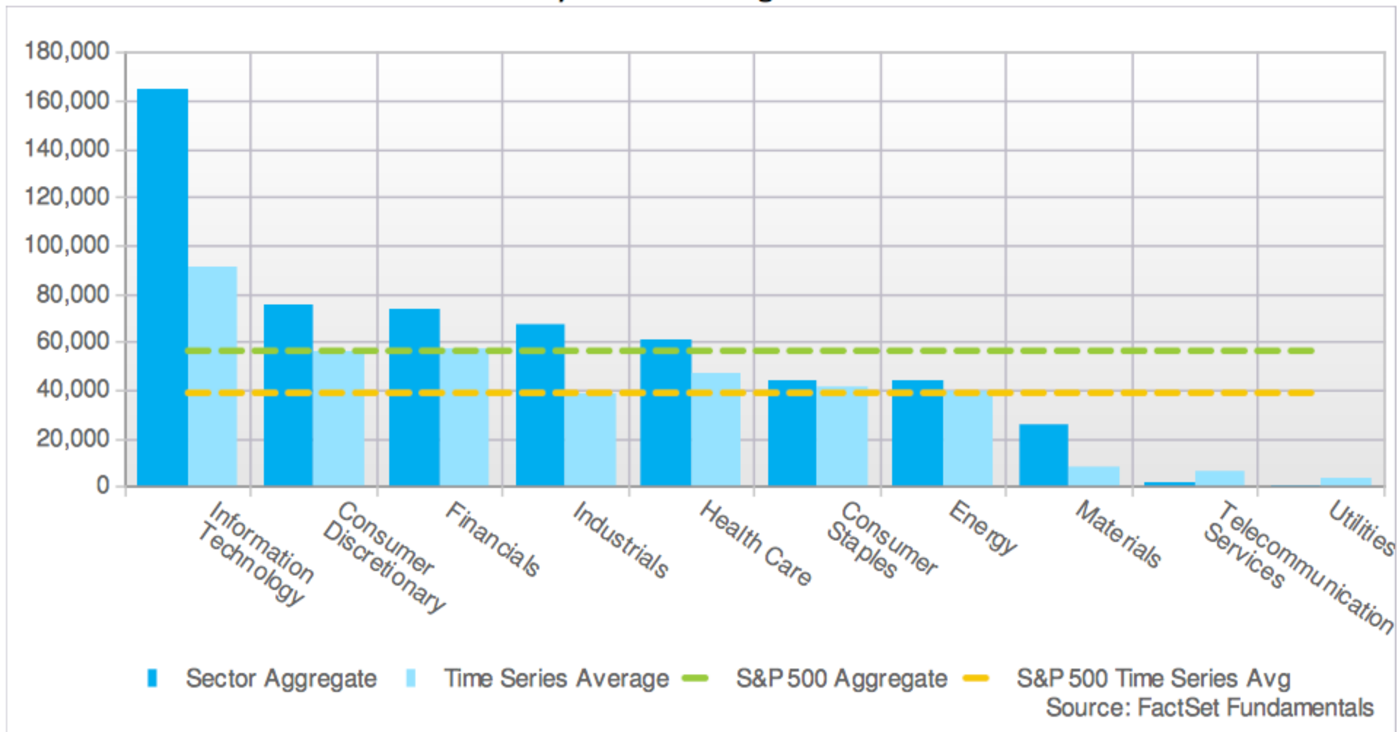
In the current year financials, utilities and industrials have seen their P/E ratios fall while energy has grown considerably due to weakening earnings from falling energy prices.

S&P 500 Trailing 12-Month P/E Ratio

Sector	3/9/2009	12/31/2014	Current	Bull Mkt Chg	YTD Chg
Telecom	9.23	14.76	14.92	5.69	0.16
Financials	neg.	15.29	15.19	--	-0.09
Energy	5.88	14.35	16.78	10.90	2.43
Utilities	9.32	18.15	16.90	7.58	-1.25
Industrials	6.55	18.18	17.64	11.09	-0.54
S&P 500	11.03	18.26	18.82	7.79	0.56
Materials	8.21	18.41	19.21	11.00	0.80
Technology	11.95	18.90	19.63	7.67	0.73
Cons. Staples	11.20	20.62	20.19	8.99	-0.43
Cons. Discret.	35.75	21.02	22.09	-13.66	1.07
Health Care	9.45	22.66	23.75	14.30	1.09

Remember that we just talked about how share buybacks can affect earnings, which then complicates the meaning of changes in PE ratios over time? So let's look at buyback trends by sector for the year 2014, (the latest period for which this data is available.)

Dollar Value Buybacks – Trailing Twelve-Month Basis

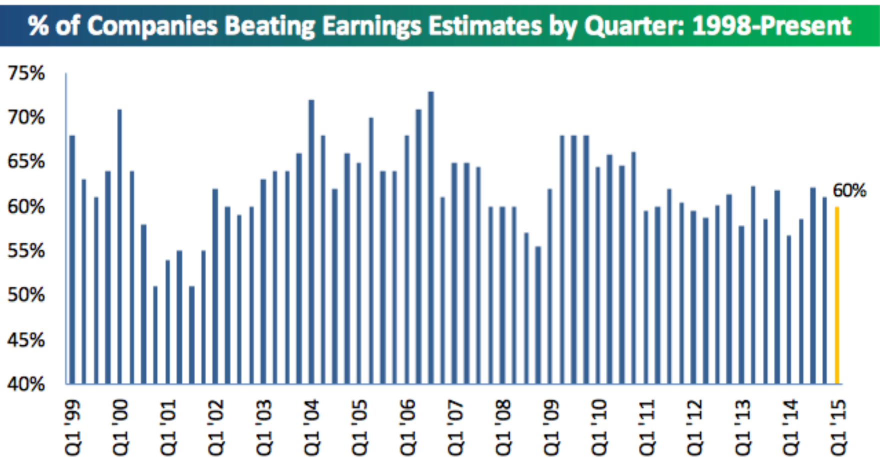


The technology sector greatly outpaced the rest of the sectors, and in fact five of the top ten companies by dollar-value buybacks for 2014 are in technology; Apple, IBM, Intel, Oracle, and Microsoft for a combined total of over $96 billion in total buybacks amongst just those five. This volume of share buybacks makes the P/E ratio lower than it would otherwise be because the "E" (earnings per share) is artificially raised when the number of shares outstanding is reduced through buybacks. Thus the comparison of the PE ratio for the technology sector relative to other sectors is misleading. In other words, the tech sector's PE has expanded by more than the 5.69 multiple points that it appears since the low of March 9, 2009, it is artificially lower thanks to these stock buybacks.

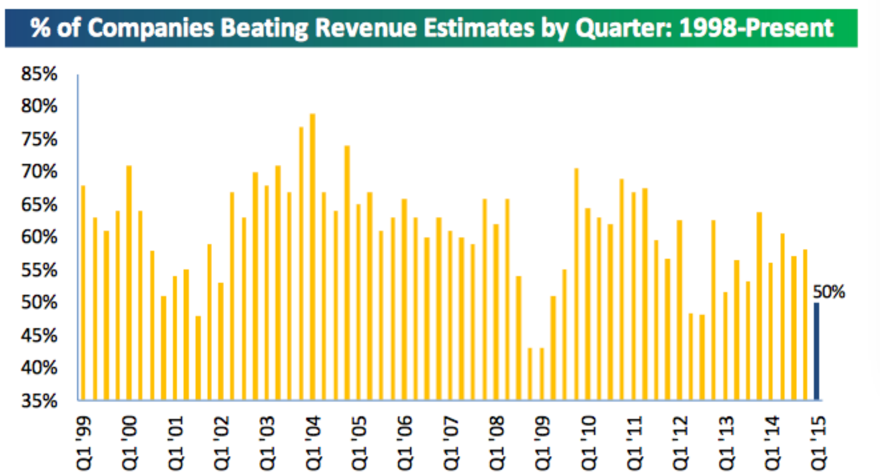
Bottom Line: *Why should investors care? We need to always be assessing if an investment is under priced, overpriced or fairly priced by the market. One way to do that is by comparing PE ratios, but we've just shown that simplistic analysis like that, which is much of what you get when you just read the headlines, can completely misinterpret the data, leading to bad investment decisions. It always pays to look a little deeper and think about what assumptions lie beneath headline statements.*

Earnings Recap

Last week the earnings season came to an end with Walmart's report, so let's look at just how everyone did in an economy that wobbled a bit in the first quarter. Out of the over 2,500 companies reporting, 60% beat consensus analyst estimates for earnings, which sounds pretty good. The chart at right shows that while not a great relative showing, it isn't awful either.



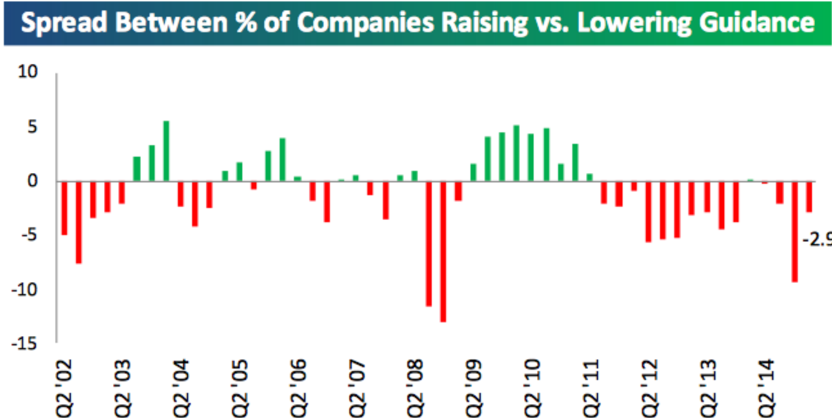
But that is about earnings which reflects changes in costs as well are revenue. So how did companies do with sales? Last quarter 50% of companies beat analysts' revenue estimates. The bottom chart at right shows how that 50% beat rate compares to historical norms. This time the picture is a bit more concerning as it is clearly below average. Keep in mind that most companies would like to consistently beat expectations by just enough to impress, but not by so much that no one pays attention to the official guidance anymore.



With a 50/50 on beating sales estimates, how about taking a look at the direction companies have been leading analysts lately.

Well there you have it. Since shortly after the financial crisis companies have primarily been guiding forward estimates down, yet even with that negative outlook, only 50% were able to beat on revenue estimates.

Let's take a look at what might have companies issuing more pessimistic guidance.

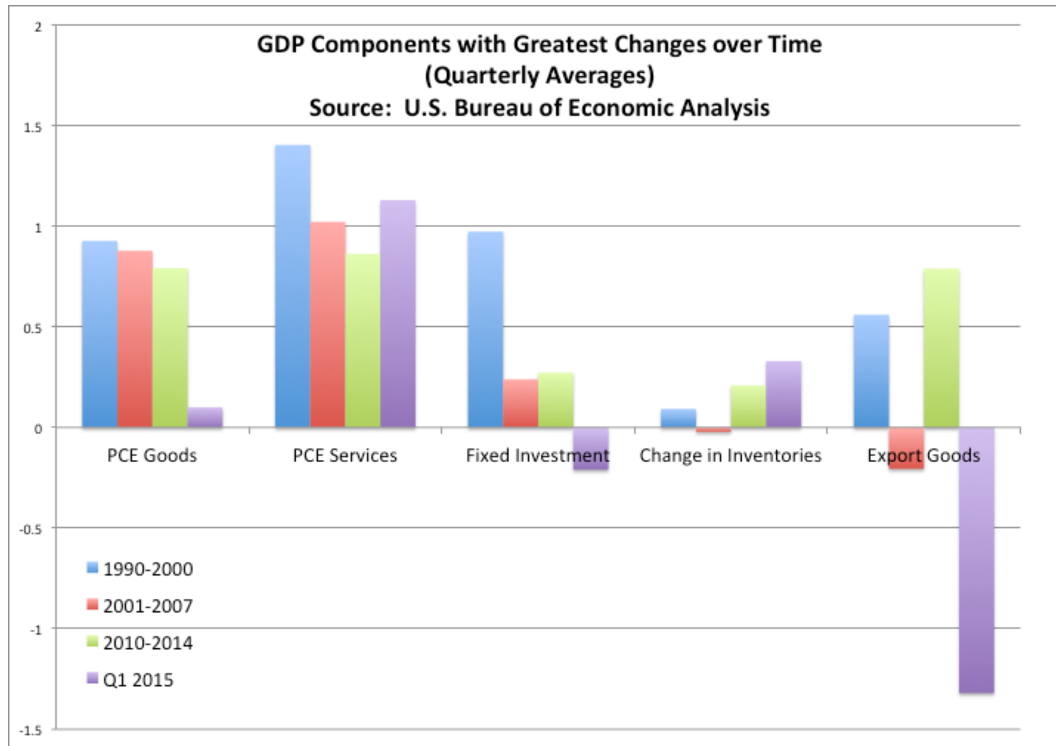


GDP and the Global Economy

Earlier this month the US Census Bureau released its Advance Monthly Sales for Retail and Food services for April, a report that many hoped would increase confidence that the lackluster economic growth in the first quarter could be blamed on the weather and port closures, by showing a robust rebound in consumer spending last month. Those hopes were dashed as retail sales for April were flat, versus expectations for 0.2% growth.

Core sales, (which excludes cars, gasoline, building materials and food services) were also unchanged versus expectations of a 0.5% increase. Overall retail sales have grown 0.9% over the past year, which is the weakest rate of growth since October 2009. Headline retail sales have now missed expectations for five consecutive months, that's the longest losing streak since 2001. The few areas of strength were online store sales, up 0.8% and restaurant and bar sales, up 0.7%. While according to Friday's Employment Situation report by the Bureau of Labor Statistics, average hourly earnings for all employees has increased by 2.2% over the past year, looks like most aren't looking to immediately spend any additional income or what they've saved thanks to lower gas prices.

We were told that low interest rates would get things moving. Interest rates remain at all time lows, (see 10 Year Treasury rate at right) and yet… If low rates were the panacea then we should have seen a pick up in the housing market by now. To us, it all gets back to job creation, wage growth and confidence that things are actually getting better, not just that we are told that is happening.



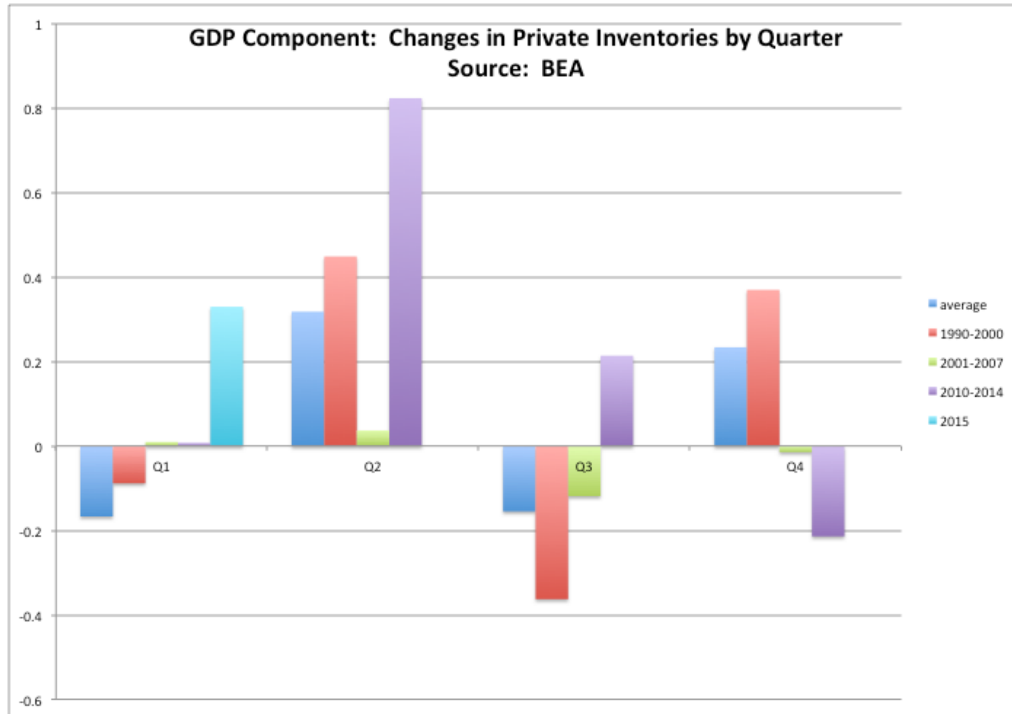
So what's going on? As we predicted first quarter GDP was just revised into contraction territory on May 29th, falling -0.7%. Just like last year's first quarter contraction, most are blaming it on the weather, but we took a deeper look. The chart at right shows the components to GDP with the greatest impact per quarter and how they have changed over time.

You'll notice that the **Private Consumption Expenditures (PCE) Goods** number has been, on average, continually dropping since the 1990s and it reduced even more dramatically last quarter. This figure represents the amount consumers have spent on goods, so basically we are in aggregate simply buying a lot less stuff. It is also interesting to note that **Private Consumption Expenditures (PCE) Services** reversed its decade-long falling trend last quarter and actually rose, which helped keep the GDP numbers from being worse. We bought less stuff last quarter but paid for more services.

Fixed investment has also been falling for decades and really took a dive last quarter. This represents, according to the U.S. Bureau of Economic Analysis, "total business spending on fixed assets, such as factories, machinery, equipment, dwellings, and inventories of raw materials, which provide the basis for future production." Gulp! This trend means businesses are reinvesting less and less into their future capabilities – no wonder the stock buybacks we keep talking about are so high!

You'll also notice that **changes in inventory** contributed positively to GDP this quarter, much more so than the historical norm. This is another big uh-oh, as it represents the difference between what was produced last quarter and what was actually sold. It is the change in stuff left on the shelves. Yikes! First, this is not surprising seeing that we are buying less stuff, but the trend is alarming. In aggregate American businesses are ending up with more and more stuff left unsold at the end of the quarter. So much for the joys of Just-in-Time production! But wait, companies may also build up inventories in one quarter because they are concerned that they won't be able to keep up with demand in the next. Perhaps businesses typically build up their inventories in Q1 because they think they are going to sell like mad in the following months?

This next chart makes us even more concerned. You'll notice that inventories actually tend to decrease during the first quarter of the year, so the fact that this year there was a sizable buildup is even more concerning. You may notice that the average for all years (the bar in blue) is lower in the first quarter than in the breakouts by time frame, which is mathematically impossible. That is because we kept 2008-2009 out of the analysis. Deep in the recession, the data from those years is such an outlier that it convolutes the analysis, thus we've excluded it.



Government spending was also supposed to help get the economy back on its feet. At the end of 2007, the US federal debt was $9.2 trillion, today it is over $18 trillion. Yes, incredibly enough the US government just ran deficits over the past 7 years equal to those for all the prior 230 years combined! That's a hell of a lot of spending and still no boom after the bust. We sympathize with those in D.C., as much of the mainstream conventional wisdom has not delivered as expected.

Europe and Japan have also added a mountain of debt, and now most global policy makers have turned over the keys to central banks, so much so that at the recent Strategic Investment Conference presented by Altegris Advisors, nary a presenter failed to drop the F-bomb (Fed in this case) at least once during their presentation. As Grant Williams pointed out, "Central banks are the single most important factor in every investment decision. That's ridiculous!" We tend to agree, but it is today's reality so as investors we'd best pay attention. Quantitative easing appears to be the last hope for many.

Out on main street things are still tough for small businesses with small business optimism, according to the National Federation of Independent Businesses, still below the historical average and many owners still wary of the future.

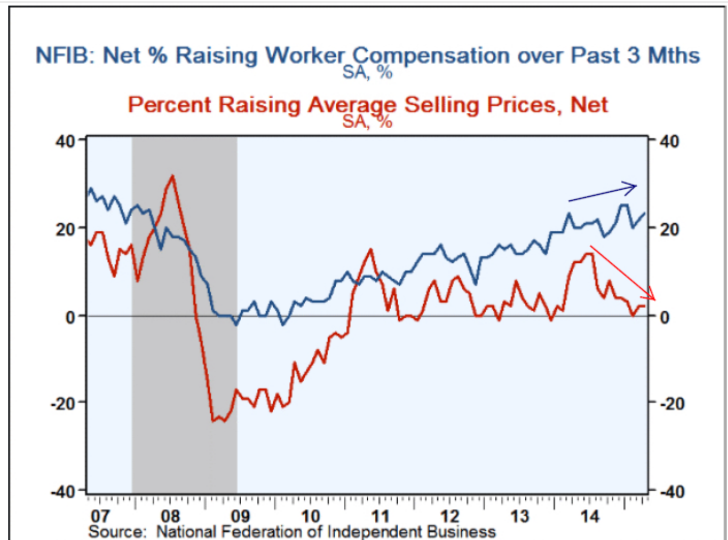
Small Business Optimism Rises 1.7 to 96.9

April increase clouded by future sales outlook

Index Component	Net %	Change From Mar
Plans to Increase Employment	11%	▲ 1
Plans to Make Capital Outlays	26%	▲ 2
Plans to Increase Inventories	4%	▲ 3
Expect Economy to Improve	-6%	▲ 1
Expect Real Sales Higher	10%	▼ -3
Current Inventory	-1%	▲ 4
Current Job Openings	27%	▲ 3
Expected Credit Conditions	-4%	▲ 2
Now a Good Time to Expand	10%	▬ 0
Earnings Trends	-16%	▲ 6

NFIB.COM/sbet

In the US the cost of labor is getting complicated. Worker compensation demands have been rising, while productivity has been falling and businesses find themselves struggling with pricing.

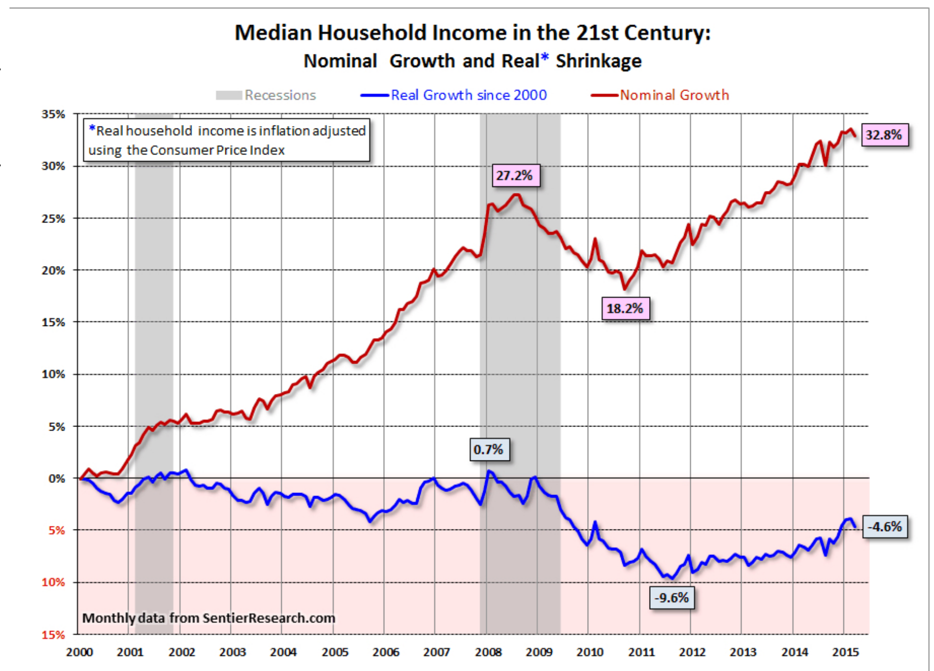


Across the pond, while the European Central Bank's quantitative easing hasn't exactly ensured the low interest rates expected, the European bloc is now growing faster than the US for the first time since 2011, growing by 0.4% in the first quarter, but still shy of expectations of 0.5%. Growth was driven surprisingly by Italy, France and Spain up 0.3%, 0.7% and 0.9% respectively with Germany missing expectations with a disappointing 0.3% growth in the first quarter.

Bottom Line: *In the US, it is increasingly about specific security selection and those picks need to take into account the demographic and economic headwinds facing the country with fewer people working, more getting benefits and more regulation in many sectors while taking advantage of longer-term bigger trends. With the likelihood for increased volatility and potential stock market wobbles as the Fed looks to raise rates, weaknesses should be viewed as buying opportunities while investors might want to consider a longer term perspective.*

Housing

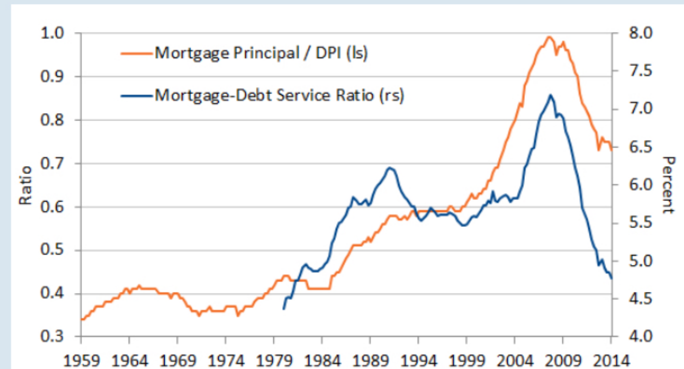
The U.S. Census Bureau announcement that April housing starts were well above expectations may have some thinking that this sector is potentially heating up. We'd be caution and suggest a deeper look at the data, pointing out that February and March starts were considerably lower than what was implied by permits, so a catch-up in starts is not surprising. We will likely see another beat next month if the catch-up continues and aren't ready yet to call this a definitive and sustainable upturn. Besides, despite the better-than-expected April Housing Starts figure, the National Association of Homebuilders (NAHB) Housing Market Index dipped month over month in May. As NAHB Chief Economist David Crowe put it, "Consumers are exhibiting caution, and want to be on more stable financial footing before purchasing a home." To us that sounds more in the snap back than sustainable upturn camp, but we'll let the data tell us what's really going on.



When it comes to home ownership, we continue to look primarily to changes in income levels and interest rates for confidence in a longer-term uptrend.

Unfortunately median household income declined in March, (latest data available) according to Sentier Research and is now 5.3% lower ($3,020) than its most recent high in January 2008 and over 4.5% below where it was in 2000.

Mortgage Debt Service and Principal Pay-Down Diverge



Source: Bloomberg BloombergBriefs.com

U.S. household de-leveraging hasn't erased all traces of the financial crisis and the housing downturn. While the mortgage debt service ratio has now retreated to a low point in comparison with the past 30 years, the amount of mortgage principal outstanding as a percentage of all U.S. disposable personal income remains higher than at any point previous to the buildup of the housing bubble in the middle of the last decade.
— *Josh Wright, Bloomberg Economist*

Despite all the hoopla over supposed household deleveraging, according to a resent Bloomberg report, "total mortgage principal outstanding as a portion of disposable income and foreclosures as a proportion of mortgage loans outstanding remain elevated relative to previous multi-decade historical averages."

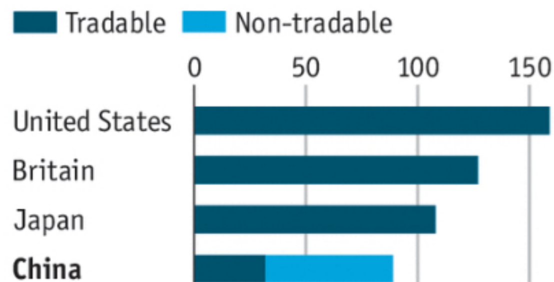
Bottom Line: *With income still weak, debt level relative to income still high and data trends pointing towards a steepening yield curve, any improvement in the housing sector is likely to be muted. The evolving demographic trends also present a headwind as the baby boomers enter retirement, they are less likely to "trade up" a house and more likely to downsize. On the other end of the age spectrum, the Millennials have shown a distinct lack of interest in owning major assets such as homes or cars, preferring renting and Uber, and are more focused on the latest and greatest technology, which given their mind-boggling student debt levels, isn't too tough to understand.*

China

Earlier we showed you the jaw-dropping performance of China's stock market over the past year, despite an economic growth rate that is starting to decline. Keep in mind the economy is still growing, just at a slower rate. Our analysis indicates that much of this run-up can be attributed to an increase in domestic demand for investment vehicles, rather than improving fundamentals. According to The Economist, almost 8 million new trading accounts were opened in the first three months of 2015 alone. In April regulators increased the number of accounts an individual can hold from 1 to 20, which led to a whopping 4 million accounts being opened on average every week since then! This increasing demand is driven by the emergence of the middle class, the relaxing of restrictions on investing, the slowly maturing capital markets and the material impact of Chinese culture which is more likely to believe that a directional move is to be jumped on such as, "black is hot tonight" at a roulette table.

A secondary market

Market capitalisation as % of GDP
April 2015



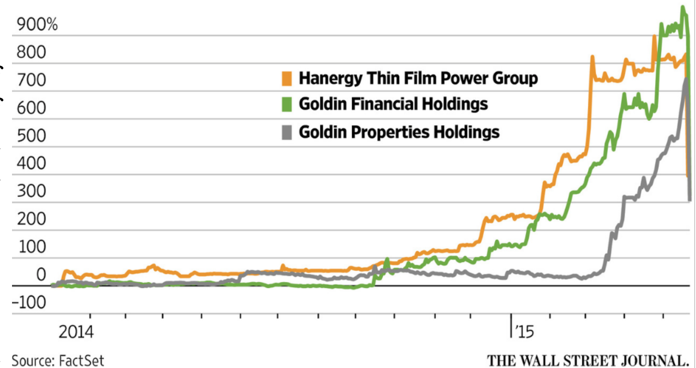
Sources: Stock exchanges; World Federation of Exchanges; IMF

Economist.com

During the last Chinese market crash of 2007, investors were unable to buy shares on credit. Now they can and the outstanding volume for share financing has reached about 3% of GDP, further expanding the demand base. To put the total market capitalization into perspective however, it accounts for less

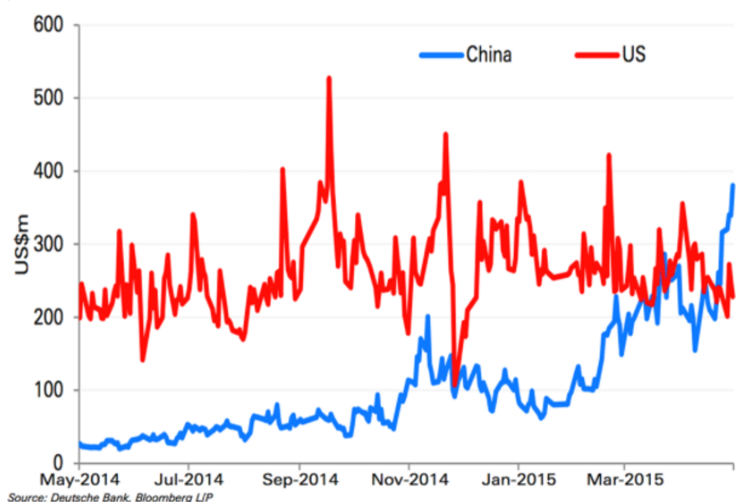
than 50% of GDP in China, versus the United States, which is well over 150% according to the World Federation of Exchanges.

The recent dramatic stumbles of two of Hong Kong's best-performing stocks, Hanergy Thin Film Power Group, and Goldin Financial Holdings/Golding Property Holdings, haven't put much of a damper on the markets' uptrends. They also did not stop FTSE Russell from announcing the launch of two emerging market indices in which Chinese A shares will have a 5 percent weighting, versus no presence previously, giving Chinese shares a larger weighting than Russia. MSCI is due to announce its own decision on the inclusion of Chinese A shares on June 9th. The expansion of Chinese presence in indices means increased demand for the shares. According to FTSE estimates, China would account for more than half of a typical emerging market portfolio if it were to meet all nine of FTSE's criteria for inclusion in emerging market indices. According to The Financial Times, the Chief Executive of FTSE Russell thinks that Chinese stocks are likely to meet the full nine criteria versus only seven today within the next two years.



May 26th, the International Monetary Fund (IMF) declared that China's currency is no longer undervalued, a milestone for the nation after more than a decade of criticism over Beijing's rigid control over the renminbi. Outside of putting the IMF at loggerheads with the US, which still claims the renminbi is significantly undervalued, this is an extremely meaningful step as we approach the IMF's review of Special Drawing Rights (SDRs) in October, a review that occurs only once every five years. Click here for details on just what the SDR is all about. What matters to investors is that China wants to be included in the basket of currencies, which today consists of just the US dollar, the Japanese Yen, the Pound Sterling and the Euro. If the IMF accepts it as part of the SDR, there are estimates that at least $1 trillion of global reserves could flood into Chinese assets. The 187 central banks in the IMF would have to hold China's currency in reserve and even more powerful, the weighting for Chinese stocks in the MSCI All Country World index could quadruple.

So while yes, the rise in Chinese stock indices over the past year has benefited dramatically from the increased demand due to the explosion in Chinese trading accounts, that jump in demand is nothing compared to what could happen if the IMF grants the nation's request to be included in its SDR. The chart at right illustrates the dramatic increase in stock buying and selling, with almost twice as much trading volume occurring in China today as in the U.S., despite China's two primary exchanges, Shanghai and Shenzhen having combine market cap that is one third that of the New York Stock Exchange and Nasdaq combined.
Yesterday's move by the IMF lends credence to the belief that China will get its wish. Keep in mind that the renminbi is currently the fifth most used currency for global transactions and is the



second most used in trade-related finance, surpassing the euro. China is the world's third largest economy, after the Eurozone and the United States and it reasonably is arguing that the inclusion of its currency would improve global liquidity in times of crisis.

Bottom Line: *For a nation focused on getting accepted into the SDR, last week Hanergy and Goldin were a bit like having the much-loved family dog track the unpleasant consequence of his morning's counter-surfing sausage raid through the house moments before dinner guests arrive; an unpleasant situation, but one that is unlikely to cancel the evening's affair. We will be watching closely for further indications that China may get its wish.*

Your Money with Greg Tull

Let's review this month what an outstanding investment opportunity it can be to have solar on your home, especially if you live in a sunny location. We'll calculate payback, annual return on investment, and expected lifetime return on investment.

Here are our assumptions: $23,000 total system cost (varies based on size of your system, panel maker, inverter, labor & installation, etc.), 30% federal tax credit (available until Dec 2016) = $6,900 federal tax credit, $16,100 net after tax installed system cost, 90% savings on your annual utility bill, a $220/month utility (electric + gas) bill before solar, and an annual growth rate of your utility bill of 3.5%. (If you'd like a copy of the spreadsheet so you can plug in your own numbers, we'll be happy to send it to you.)

In the first year, your savings is $2,376, second year savings is $2,459, third year is $2,545 and so on, with your savings growing at 3.5% per year, since your cost per kilowatt hour (kwh) is fixed with solar, while the cost of power from your utility company is growing at 3.5% per year. At the end of year 6 in this example, your cumulative savings on your utility bill is $15,563, so you have fully recovered your net after tax investment in the system ("payback") a couple of months after the end of year 6.

If we assume that your own personal solar power generating station that you install on your roof will last 30 years (it may last 35 years), the cumulative savings on your utility bill is projected to be $122,655. That amounts to a total return on your initial investment of 860%, or 7.6x the $16,100 that you paid after tax to purchase and install the system. The internal rate of return (IRR) is 18% annualized over 30 years, which compares to the long run average rate of return of the US stock market of about 9%, and of the US intermediate term investment grade bond market of about 5%.

The example above assumes that you make the $16,100 net investment yourself, using your capital. Tune in next month when we'll explore a couple of financing options with which you can begin saving money with solar every month from the very first month, even with no money out of pocket, meaning none of your own capital at all, purchase (or lease) the system and have it installed.

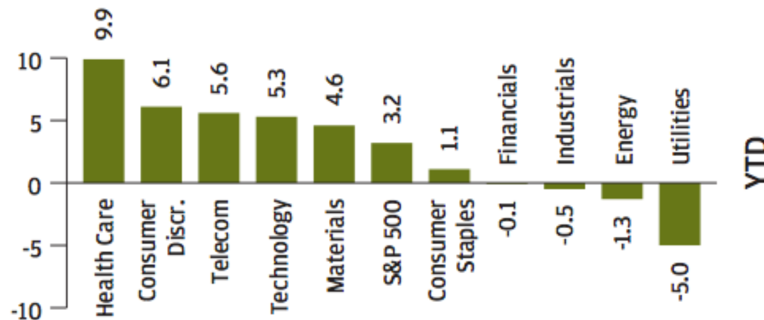
Market Recap

(as of May 29nd, 2015)

Equities	Level	1 week	QTD	YTD	1 year	3-yr. Cum.
		Index Returns (%)				
S&P 500	2107	-0.84	2.26	3.23	12.01	68.63
Dow Jones 30	18011	-1.18	1.69	2.06	10.40	53.95
Russell 2000	3098	-0.43	-0.33	3.98	10.78	67.09
Russell 1000 Growth	668.47	-0.99	1.92	5.83	14.92	68.51
Russell 1000 Value	637.58	-0.68	2.15	1.41	9.15	70.44
MSCI EAFE	1899	-1.82	3.75	8.93	0.00	53.06
MSCI EM	1004	-3.18	3.42	5.78	-0.72	18.26
NASDAQ	5070	-0.37	3.65	7.57	20.74	83.55

Fixed Income	Yield	1 week	QTD	YTD	1 year	3-yr. Cum.
U.S. Aggregate	2.19	0.62	-0.60	1.00	3.00	7.32
U.S. Corporates	3.10	0.86	-1.35	0.94	2.66	13.36
Municipals (10yr)	2.22	0.52	-0.92	0.33	3.02	9.88
High Yield	6.39	0.17	1.51	4.07	2.04	26.10

Key Rates	5/29/15	5/22/15	3/31/15	12/31/14	5/29/14	5/29/12
	Levels (%)					
2-yr U.S. Treasuries	0.61	0.64	0.56	0.67	0.37	0.30
10-yr U.S. Treasuries	2.12	2.21	1.94	2.17	2.45	1.74
30-yr U.S. Treasuries	2.88	2.99	2.54	2.75	3.31	2.85
10-yr German Bund	0.49	0.60	0.15	0.53	1.35	1.36
3-mo. LIBOR	0.28	0.28	0.27	0.26	0.23	0.47
3-mo. EURIBOR	N/A	-0.01	0.02	0.08	N/A	0.68
6-mo. CD rate	N/A	N/A	N/A	0.27	0.27	0.47
30-yr fixed mortgage	4.07	4.07	3.89	4.04	4.31	3.91
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



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